

Rating-Agentur Expert RA confirmed at 'BB-' the ratings of Uzbekistan. The rating outlook is stable.

Rating-Agentur Expert RA confirmed the sovereign government credit rating (SGC) of Uzbekistan at 'BB-' (Sufficient level of creditworthiness of the government) and at 'BB-' (Sufficient level of creditworthiness of the government) in foreign currency. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- While Uzbekistan's sovereign debt to GDP has more than doubled over the past two years and the government continues to pursue a policy of active borrowing, the overall debt burden remained one of the lowest among the CIS countries at 20,5% of GDP and 73,5% of budget revenues at the end of 2018. Moreover, the maturity and terms of the obligations are favorable, as long-term loans with deferred repayments account for most of the external debt and are provided mainly by international institutions, China and Japan;
- The IMF estimates the consolidated budget¹ surplus at 2,2% in 2018, which was driven by increased tax revenues as well as favorable prices for exported goods, combined with the liberalization of FX transactions. At the same time, taking into account policy-based lending² and off-budget operations, the overall budget balance is negative and estimated at -2,1%, which represents a low credit risk according to our internal benchmarks. In 2019, the tax reform will cause a weakening on tax revenues; however, with the planned reduction in lending to SOEs, we expect an overall deficit in the range of 1,5-2%, which will not put additional pressure on public finances;
- The economic pace set in 2018 with real GDP growth at 5,1% is expected to continue in the medium term supported by the expansion of capital investments, high activity in major industry sectors, construction, and services, and stimulated by high domestic consumption and bank lending. We expect the growth in 2019-2021 at 5,5%-6% of GDP, whereas the long-term progress will depend on the successful modernization of the massive state-owned sector;
- On the background of active involvement and support from the state, the banking system shows stability, retaining ROA at 2%, capital-to-assets ratio at 11,3% and officially recorded NPLs at 1,5% of total loans as of the end of 2Q 2019. However, we see potential risks in the banking system related to the high concentration (about 85%) of state-owned banks, strong government influence and controlled distribution of credit resources. As a result, the market role of banks is limited, and there are increased risks of materialization of contingent liabilities, especially taking into account the recent financial distress of several SOEs after FX-liberalization.

Restricting factors:

- Given the dominance of FX-denominated obligations in the structure of public debt (98%) and the weakness of the national currency, the debt position is vulnerable to exchange rate fluctuations. Since the beginning of 2019, the national currency has depreciated by

¹ Consolidated fiscal balance includes revenues and expenditures for extra budgetary funds (primarily the Fund for Reconstruction and Development), lending and borrowing, and externally financed expenditures.

² Policy-based lending operations include investment project financing and on-lending by the FRD, recapitalization or capital injections in SOEs including state banks, and loans extended to construct affordable housing in rural and urban areas.

12%, which led to an increase in the debt burden. The government is diversifying the structure of its debt by launching from December 2018 the issuance of USZ-denominated domestic bonds to cover the budget deficit, but the share of such obligations remains insignificant, about 2% at the end of 2Q 2019;

- The growth of imports to 38% of GDP in 2018, amidst the liberalization of currency transactions and trade, as well as increased demand for investment in the modernization of the economy, resulted in an expansion of the trade deficit to 9,6%, compared to 2,1% in 2017. We expect the current trend in foreign trade to continue in 2019 as export demand weakens and imports are stably high, nevertheless a moderate debt level and its favorable maturity, as well as sound foreign exchange reserves covering almost 13 months of imports support the external position of Uzbekistan;
- The ratio of banking system assets and domestic loans to GDP has grown rapidly over the last several years, reaching 53% and 41% in 2018, compared to 35% and 22% in 2016 respectively. Although these indicators are still at a moderate level, the accelerated growth of lending carries potential risks of overheating the economy; moreover, a significant share of loans is directed lending to SOEs, which limits the effectiveness of the market role of the banking sector;
- Enhancement of the methodology for recording the unemployed population revealed in 2018 that the real unemployment rate is much higher and amounts to 9,3% compared to the previously declared 5,8% in 2017. The economy's current condition has forced more than two million people to migrate to Russia and Kazakhstan for work. Consequently, the deterioration of the economies of these countries may cause an even greater surge of unemployment;
- Intending to reduce inflation pressure, the Central Bank of Uzbekistan (CBU) is pursuing a tight monetary policy, keeping the refinancing rate at 16% after an increase of 2p.p. in 2018. Besides, adhering to the free float exchange rate regime, the CBU conducts neutral interventions mainly to sterilize the purchase of gold for foreign currency, smoothing out only sharp fluctuations in FX rates. However, the efficiency of the monetary transmission mechanism is limited by the availability of preferential lending to SOEs at below-market rates, as well as by the steady financial dollarization;
- The commitment to tax reforms initiated in 2018 and the conservative fiscal policy remains in 2019. The government plans to reduce the overall budget deficit below 2% of GDP by reducing off-budget operations. At the same time, we observe risks of deviations from this policy if substantial preferential lending to state-owned companies and financing of social programs will continue;
- Uzbekistan is one of the leading countries in the world in terms of diversity and availability of natural resources (mainly gold and natural gas), which contributes to sustainable economic growth. At the same time, the country has long been in a water crisis, the severity of which may increase with the reduction of water resources amid the melting of mountain glaciers due to global climate change. Agriculture is the most exposed to water risk, accounting for more than 30% of gross value added.

Negative factors:

- Due to successful economic growth, GDP per capita in PPP terms over the past five years has expanded by 44% to USD 7,5 th. However, Uzbekistan remains lagging other peers in the Central Asian region. Furthermore, the unadjusted HDI as of 2017 also remained extremely low, at 0,71 (105th place among 189 countries);
- The high volatility of inflation since 2017, triggered by price liberalization, persists. After a significant surge in energy and food and prices as a result of the low base effect, annual inflation peaked in the beginning of 2018 to 20,5% but then gradually slowed to 13% y-o-y in January 2019. However, the increase resumed once again in February and we expect the inflation rate to slightly exceed the CBU's forecast corridor of 13,5%-15,5% at the end

of the year as a result of further adjustment of regulated prices to market prices, the expansion of the VAT and the growing domestic demand spurred by increased wages and active bank lending;

- Institutional development continues to be hampered by the high level of corruption and the presence of various legislative barriers and procedures, which complicate the running of business. According to the Transparency International, the Corruption Perception Index was 23th out of 100 in 2018, and in the World Bank's Ease of Doing Business Uzbekistan ranked 20th among 23 countries of Europe and Central Asia;
- The functioning of the capital market is restricted by the existing state regulation and lack of demand from the market. A limited number of participants with a narrow range of financial instruments and a high concentration of trades represent the stock market. Moreover, the capitalization of national companies on the market is just over 5% of GDP. However, stock exchange trade more than doubled in 2018 as compared to 2017.

Stress factors:

- The level of financial dollarization has not decreased, as there is a high demand for lending in foreign currency and still not enough confidence of the population in the national currency. In August 2019, the share of foreign currency in total loans and deposits reached 43% and 57%, respectively (very weak stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Ensuring macroeconomic stability, economic growth and reduction of unemployment through a smooth continuation of the initiated reforms and restructuring of the public business sector;
- Prudent and transparent fiscal policy focused on diversifying revenue sources and significant curtailing of policy lending programs;
- Improving the efficiency of monetary policy, its consistency and providing more freedom to monetary authorities, resulting in a long-term and controlled reduction of inflation and levels of financial dollarization.

The following developments could lead to a downgrade:

- Strong growth of directed lending with concentration in state banks, which may lead to increased external imbalances, higher inflation and materialization of contingent liabilities;
- Sharp increase of dollarization levels due to adverse conditions on the FX-market;
- Elevation of the government debt load due to devaluation of UZS, taking into account the high share of FX-denominated debt.

“The confirmation of Uzbekistan's ratings at ‘BB-’ with a stable outlook is driven by the country's strong economic growth, prudent government finances with moderate levels of public debt and improved transparency and governance in fiscal and monetary policies. The ratings are also supported by the fast-growing banking sector, which maintains a favorable level of capitalization, asset quality and profit.

On the negative side, the ratings continue to be constrained by elevated unemployment levels, low institutional development, high corruption and depressed level of GDP per capita, one of the lowest in the region. Additionally, high inflation and exchange rate volatility also have a negative impact on the creditworthiness, aggravated by limited monetary policy, the effectiveness of which is undermined by heavy segmentation of bank lending, high level of financial dollarization and undeveloped local capital market.” – Clarified Vladimir Gorchakov, Associate Director of Rating-Agentur Expert RA.

Research report on Uzbekistan is available at:

https://raexpert.eu/reports/Research_report_Uzbekistan_06.09.2019.pdf

Next scheduled rating publication: TBD in December 2019. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2019](#)

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
08.03.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
14.09.2018	Scheduled revision of both types of ratings for the country	B+	B+	Positive	Positive
16.03.2018	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
22.09.2017	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
24.03.2017	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
23.09.2016	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
15.04.2016	First assignment of both types of ratings for the country	B+	B	NA	NA

Minute's summary

The rating committee for Uzbekistan was held on 4 September 2019. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: [Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version](#) (from April 2019). Descriptions and definitions of all rating categories can be found under the [Rating scale](#) section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for [Internal policies](#).

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, CIA Fact book, World Economic Forum, Doing Business, United Nations, The State Committee of the Republic of Uzbekistan on Statistics, Central Bank of Uzbekistan (CBU), Asian development bank, Ministry of Finance of Uzbekistan, The State Committee of the Republic of Uzbekistan for Privatization, Demonopolization and Development of Competition, Transparency International

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

Risk warning

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.